How to tackle sovereign ESG scoring in low-income economies

Investors face multiple challenges when evaluating sovereign ESG risks and opportunities.

FTSE Russell highlights one important challenge when evaluating sovereign ESG risks and opportunities, the so-called "Ingrained Income Bias" (IIB), first introduced by the World Bank in its paper "A New Dawn – Rethinking Sovereign ESG".

It points out that it's beneficial to look at ESG ratings in the context of a country's income level and economic strength in order to adjust for biases against developing countries. It is precisely these countries – which in the investment world are grouped together as the emerging markets – that arguably need the majority (over 60% according to UNCTAD) of the USD5–7 trillion per year in investments necessary to achieve the UN Sustainable Development Goals by 2030.

To gain the full picture, this analysis needs to be put into context with the likely future ESG trajectory of sovereign issuers, which ex-post data can shed only limited light on. This is where engagement with sovereign issuers and the forward-looking granular analysis of underlying data needs to step in.

The World Bank draws a similar conclusion, highlighting that simplistic income adjustments of underlying data might lead to overcorrection. It suggests putting greater emphasis on in-country, rather than between-country, comparisons and peer group analysis.

Positively, we believe that sovereign fixed income investors are, to a large extent, already making these income adjustments when evaluating sovereign credit risks – perhaps with the exception of environmental/climate risks, which are yet to be priced in.

The accurate pricing and analysis of environmental risks is further complicated by a lack of consensus around measurement. But at a high level, our analysis showed that once all economic differences are factored out, the spread of the leading ESG performers is approximately 70% lower than the worst performers.

Further dilemmas of sovereign issuers include, to name but a few:

- How do you offset robust performance within one category (e.g. environmental policies) with a poor track record in another (e.g. human rights) – is performance across E, S & G really additive?
- What's the best way of measuring a country's performance in the environmental dimension?
- Which sovereign ESG provider ratings do you believe accurately represent reality, given the notoriously low correlations among data providers?
- Do you factor in ESG risks and opportunities in a same way when investing in short-dated sovereign T-bills vs. 100-year bonds?

Ongoing challenges in ESG sovereign analysis mean it remains more of an art than a science. To give it justice, such analysis needs to be multi-dimensional and quantitative data needs to be overlayed with forward-looking qualitative analysis. This should be supplemented by frequent engagement evaluating the future path of a sovereign. In our view, relying on backwards-looking quantitative data is to the detriment of issuers and investors alike.

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